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SUBJECT: CAN BRAZIL SAVE THE BOLIVIAN GAS SECTOR?

Classified By: EcoPol Chief Mike Hammer for reasons 1.4 (b) and (d).

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Summary  
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11. (C) The Bolivia gas sector appears headed for crisis. Currently out of compliance with 3 out of 4 major international contracts, the industry faces increasing commitments to the Argentine market and growing demand at home. The government realizes it needs investment and, after over a year of hostile actions directed at Brazilian interests, it is reaching out to Brazil to reinvigorate the hydrocarbon sector. A number of agreements have reportedly been reached in advance of President Lula's upcoming visit to Bolivia on December 11-12, which is being trumpeted as a harbinger for substantial new hydrocarbon development. In reality, however, additional Brazilian investment will do little to alleviate the near-term gas shortages and will not be nearly enough for Bolivia to meet its long-term obligations -- nor will it provide the much needed economic boost Evo Morales would like. End Summary.

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Bolivian Reality  
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12. (SBU) Gas production in Bolivia has fallen slightly from a peak of 40.7 million cubic meters of gas per day (MMm3/d) in 2006, to current production levels which vary between 38 and 39MMm3/d. Contractual obligations would consume all of Bolivia's production, but the Bolivian state hydrocarbon company (YPFB) decided about two months ago to not supply any gas to Comgas, a Brazilian provider, or the Cuiaba electrical generator, located in western Brazil. This gave them an additional 2MMm3/d, but even then rising domestic demand (currently at 6MMm3/d) and Brazilian demands that Bolivia supply the maximum amount of gas allowed under the contract to Sao Paulo together consume a total of 37.5MMm3/d. (Note: The Brazilian contract dictates that up to 31.5MMm3/d be put in the pipeline so that the contractual maximum of 30MMm3/d arrives in Sao Paulo -- gas is burned along the way to power

the pipeline. End Note.) This means that only between 1.5 to 2.5MMm3/d is available for an Argentine contract which calls for a minimum contractual amount of 4.6MMm3/d. Moreover, and ominously for the Bolivian industry, the Argentine contract additionally calls for a "ramp-up" in production to 27.7MMm3/d by 2010. (Note: It was recently made public that Enarsa, Argentina's state-run energy company, is demanding payment for undelivered gas due to a 'take or pay' provision in the contract. The two countries are currently in negotiations to settle the dispute. End Note.) In sum, to meet current contractual obligations, envisioned additional industrial uses (Jindal's Mutun steel project), and domestic demand estimates, Bolivia would need to nearly double its output by 2011.

13. (C) Bolivia clearly needs to find more gas, and recent announcements of upcoming agreements with Petrobras are being spun as possible ways to avoid crisis and reestablish reliable and increasing supplies. Investment commitments are being announced in the press and will likely be confirmed when President Lula visits La Paz on December 11-12. (Note: Chilean President Bachelet will also attend to allegedly discuss proposed bi-oceanic connections among other themes, but her presence at meetings focused on the gas industry may suggest that Bolivian deals with Chile may also be in the works. End note.) According to Auturo Castanos, Petrobras representative in La Paz and former head of YPFB, Bolivian negotiators want investment and production increases "Now!" Furthermore, other companies are expected to follow Petrobras' lead on investment, so the government is putting particular importance on negotiations with the Brazilian company. Bolivia's desires, however, do not mesh with reality within the hydrocarbon sector.

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Industry Reality  
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14. (C) The mood of hydrocarbon companies operating in Bolivia is best summed up by Castanos when he said that "no one wants to be here." Ideally, companies just want to recuperate their sunk costs and sell out if they can. He emphasized that not one dollar had been invested in Bolivia from a company not present prior to the 2006 "nationalization." Announcements of investments must be looked at with this overall sentiment in mind, and thus be analyzed as ways that companies are merely attempting to maintain production and recoup investment.

15. (C) Looking at the data provided by YPFB, the lack of exploration and development of Bolivia's gas resources becomes clear. In 2000, there were 14 exploratory wells (wells being drilled outside of established fields). By 2006, this figure had dropped to three and according to Castanos, two of these wells came up dry and the results from the other well are still unknown. The story is similar when looking at developmental wells (wells being drilled within established fields). In 2000, there were 10 such drilling operations, currently there is only one. In Castanos' view, there will be no significant new production in Bolivia before 2010, regardless of any investment decisions made today. Moreover, he felt that it was unclear whether gas would again flow to Cuiaba, which has already started to operate with diesel. This is especially true if there is a successful groundbreaking at the Mutun iron deposits to which YPFB has committed 8MMm3/d for 2011. The viability of this project appears at risk due to the unrealistic commitment of cheap gas.

16. (C) In addition to the time constraints of gas exploration and drilling (18 months is a common industry estimate for the time it takes to initiate exploration and obtain production), the Bolivian context adds additional delays. Recent strengthening of environmental regulations

and more active and empowered local indigenous populations have delayed several projects. For example, to lay the new pipeline to Tarija, separate agreements had to be signed with each indigenous group whose land the pipeline traversed along the way. A new well being contemplated by the Chaco Oil Company has been delayed by over four months while they wait for the environmental permit. In a view shared across the industry, Castanos said that there really isn't environmental protection in Bolivia, just extortion by local groups. The problem may grow worse with the recent signing into law of the UN Declaration on the Rights of Indigenous Peoples.

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Brazilian Negotiations  
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¶7. (C) It is expected that a large portion of any announced investment plans will go simply to maintaining current production levels; moreover, much of Brazilian investment might simply be applied to the purchase from Total of the rights to the large Itau field. These "investments" do not represent additional production, but rather the simple transfer of an existing asset. That said, Petrobras will likely develop the field, but Castanos estimates that it will only represent between 7-9MMm3/d of additional production by 2010; a far cry from the approximately additional 30MMm3/d called for by the Argentine contract and Mutun project alone.

¶8. (C) Beyond the investments and production that Bolivia is calling for in negotiations, Castano pointed to two other sticking points. The first is that Bolivia is asking for Brazil to lower its demand from 30MMm3/d to 27MMm3/d in order to free up gas for the Argentine contract. Brazil is unlikely to cede on this issue and gas exports to Brazil must, by contract, be fulfilled before exports to Argentina.

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In fact, Jorge Luiz Kauer, General Manager of Transierra, a pipeline operator, told Econoff that over the last month he has been unable to do any maintenance on the pipeline because Petrobras is demanding the full contractual delivery of gas 24 hours a day. Some 90% of Brazilian electricity is from hydropower and with dam reserves at low levels, Castanos contends that Brazil cannot afford to cut the level of gas being used for electrical generation.

¶9. (C) Lastly, Bolivia is seeking a premium for its "wet gas." This refers to the higher content of propane and butane in exported gas because Bolivia has yet to construct a separation facility to process out these more valuable bi-products. The end result is that Bolivian gas does have a higher BTU value, and Bolivia is seeking a higher price to reflect that. Media reports on November 23 indicate a possible agreement on this issue.

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Lula and the Political Angle  
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¶10. (C) Beyond the effort to maintain current supplies, Castanos saw a political agenda motivating the Lula administration to negotiate further contracts with Bolivia. First, he believes that Lula is seeking a method to counteract Venezuelan influence in Bolivia through increased economic ties. Chavez has announced grandiose projects in Bolivia, but the only thing to emerge from two years of promised investments have been random checks distributed to local authorities. Second, Castanos thinks that Lula is trying to show himself as a leader in regional affairs. He took some hard hits domestically over Bolivian nationalization, and is now trying to show himself as a leader who can negotiate and land deals with his neighbors. In a separate conversation, Oscar Serrate, Vice President of Transredes, opined that by bringing in Bachelet to the meetings, Lula is attempting to involve Chile to further mitigate the Venezuelan influence. Finally, Petrobras does

not always walk hand in hand with the Brazilian government. It is a separate entity, and Serrate believes that many devils will emerge in the details when Petrobras begins to elaborate its investment plans. Petrobras has been burned once by Bolivia; it will be very cautious in making any further commitments.

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Comment  
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¶11. (C) Perhaps the Bolivian government now realizes that YPFB cannot meet the investment needs of the sector even with the help of the Venezuelans. It sees a train wreck approaching and is reaching out to the Brazilians for help. Despite the harsh rhetoric and actions directed at Brazil over the past year, investment may indeed be forthcoming, but it will be too little and too late to help the Morales government improve the economic outlook in the short term. Indeed, Bolivia will likely pass through jarring economic times before it again sees the foreign investment necessary to effectively exploit its hydrocarbon resources. Brazil is interested in its own political image and in guaranteeing its current gas supplies. While the promise of a shared agenda is obvious, domestic political realities will keep Bolivia from being a reliable economic partner. Investors, including Petrobras, know this and will work to protect committed assets, but are unlikely to deliver much more until a more stable political environment emerges.

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